

TAX ACCOUNTING

BY JAMES E. SALLES

The courts were relatively quiet on tax accounting issues in the first few weeks of the new year. However, there has been a spate of legislative and administrative developments on various fronts.

INDOPCO REGS STILL IN PROCESS

In an interview, Christine Turgeon of the Treasury's Office of Tax Legislative Counsel confirmed that work was continuing on the promised proposed regulations addressing general capitalization questions.¹ Although acknowledging that a "facts and circumstances" approach cannot be avoided in describing the general distinction between a capital outlay and a deductible expense, Turgeon stated that various possible *de minimis* thresholds and safe harbors, as well as other simplifying options such as a repair allowance, remain under active consideration.² Another high-profile open question is how to address the issue of capitalizing regular operating costs relating to intangible property in light of the recent appellate court decisions in the *Wells Fargo*³ and *PNC*⁴ cases.

AIRLINE REPAIR COSTS

Last month's column discussed Revenue Ruling 2001-4,⁵ addressing airlines' deductions for the cost of periodic aircraft maintenance. The IRS has now formally amended the "automatic consent" revenue procedure⁶ to cover changes in accounting method to conform to the new ruling.⁷ In a related development, the head of the IRS's Large and Midsize Business Division, Larry Langdon, has been quoted as saying that negotiations were proceeding toward a hoped-for industry-wide settlement of the continuing controversy.⁸

CHANGING BACK TO INSTALLMENT REPORTING

The IRS has moved to implement Congress's retroactive repeal of the ban on accrual taxpayers' use of

installment accounting⁹ by granting affected taxpayers consent to retroactively change from the accrual method to the installment method by filing appropriate amended returns. Taxpayers may make the change until the statute of limitations runs for any year in which installment payments were received.¹⁰

THE "MERCHANDISE" CONTROVERSY

Following a string of court losses described in earlier columns,¹¹ the IRS has now announced that, pending further guidance, it will no longer press the issue of whether "construction contractors involved in paving, painting, roofing, drywall, and landscaping" are required to use accrual accounting because they sell "merchandise."¹² The IRS continues to raise the "merchandise" issue when other types of taxpayers are involved. For example, a recent Tax Court petition contests an IRS attempt to make a commercial slaughterhouse inventory its carcasses and use accrual accounting. The taxpayers contend that the slaughterhouse should not have to maintain inventories because it did not take title to the livestock but made its profits from "slaughtering fees."¹³

Meanwhile, Senator Christopher S. ("Kit") Bond (R-Mo.), Chairman of the Senate Small Business Committee, has reintroduced his last year's proposal¹⁴ to permit taxpayers with up to \$5 million in gross revenues to continue to use cash accounting, even if they have inventories.¹⁵ Congressman Wally Herger (R-Ca.) has introduced companion legislation in the House.¹⁶

"SAFE HARBOR" REVENUE PROCEDURES

The IRS has issued two revenue procedures prescribing specialized "safe harbor" accounting methods. Revenue Procedure 2000-23¹⁷ prescribes a simplified dollar-value LIFO method for used cars and trucks (the "Used Vehicle Alternative LIFO

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Method") under which the relevant price indices are determined by reference to published price guides.

Revenue Procedure 2000-24¹⁸ addresses the common situation in which an insurance company makes advances to its agents to be repaid from future commissions. The issue in these cases is whether the company has made a loan that is unconditionally repayable in cash or an advance payment for services that is immediately reportable as income,¹⁹ and the outcome turns on the nuances of the agreement between the parties and the particular facts and circumstances.²⁰ The procedure provides that the IRS will respect an insurance company's cash advance to its agent as a loan if the parties' agreement so characterizes it and provides for adequate interest, the company consistently treats it as such, and the agent is personally liable for repayment.

SMALL BANKS' INTEREST INCOME

Code Section 1281 requires holders of certain short-term debt instruments to include both discount income and stated interest on an accrual basis, regardless of their general method of accounting. The IRS has long argued that this provision requires cash method banks to accrue interest income on routine short-term loans, either because that interest is "acquisition discount" subject to Section 1281(a)(1) or because Section 1281(a)(2) requires banks to accrue all interest income regardless of whether there is discount or not. However, the Tax Court, the Eighth Circuit, and the Tenth Circuit have all held that Code Section 1281 does not apply to banks' loans in the ordinary course of business,²¹ although these holdings are of limited application because virtually all banks of significant size report on an accrual basis.²²

The IRS has now announced that it will no longer litigate this issue²³ and modified the revenue procedure granting "automatic consent" to accounting method changes to allow cash-method taxpayers to stop accruing this interest income.²⁴ The change may be made on amended returns for past years as long as the statute of

limitations has not run for the proposed year of change or any later year. Note, however, that the new IRS position is confined to loans made in the ordinary course of business by cash method taxpayers. The IRS may still argue that other types of short-term loans have "acquisition discount," and accrual taxpayers must accrue interest income regardless of whether Code Section 1281 applies.

INVENTORY "FLOOR STOCKS"

Finally, the IRS has issued Revenue Ruling 2001-8, addressing payments made or received by dealers with respect to their "floor stocks" of inventory goods. Such payments can include taxes paid — and refunds of taxes previously paid — on such goods, as well as various types of subsidies. To the extent attributable to goods on hand as of year-end, they are treated as adjustments to inventory basis.

Revenue Ruling 2001-8 provides that taxpayers must treat floor stock payments as relating to the goods physically on hand on the date as of which the payments are computed, although LIFO taxpayers may simplify the necessary computations by assuming that the goods physically on hand on that date are those most recently acquired or produced. On the other hand, which goods remain in inventory as of year end is determined under the taxpayer's normal inventory accounting method (FIFO, LIFO, or specific identification). This means that some floor stock payments may be attributed to goods that under the taxpayer's inventory were already included in computing the cost of goods sold in a previous year. If that happens, the payments will be allowed as additional cost of goods sold, or treated as "tax benefit" income, in the current taxable year. Several examples are provided applying these principles in various situations involving LIFO accounting.

The IRS will not apply the new ruling adversely to taxpayers with respect to payments received on or before February 26, 2001, automatic consent being granted for any necessary accounting method change as to payments received after that date.

1. See discussion in J. Salles, "Tax Accounting," 1(10) *Corp. Bus. Tax'n Monthly* 32, 33 (July, 2000).

2. L. Sheppard, "Participants Consider *INDOPCO*, Alternative Minimum Tax," 90 *Tax Notes* 992, 992-94 (Feb. 19, 2001).

3. *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), discussed

in J. Salles, "Tax Accounting," 2(2) *Corp. Bus. Tax'n Monthly* 35, 35-36 (Nov. 2000).

4. *PNC Bancorp v. Commissioner*, 212 F.3d 822 (3d Cir. 2000), discussed in J. Salles, "Tax Accounting," 1(11) *Corp. Bus. Tax'n Monthly* 26, 26-28 (August, 2000).

5. 2001-3 IRB 1.

6. Rev. Proc. 99-49, 1999-52 IRB 725, discussed in J. Salles, "Tax Accounting," 1(6) *Corp. Bus. Tax'n Monthly* 29, 29-30 (March, 2000).
7. Notice 2001-23, 2001-12 IRB 1.
8. "IRS Negotiating Resolution of *INDOPCO*-Type Issues With Two Industries," 90 *Tax Notes* 728 (Feb. 5, 2001).
9. Installment Tax Correction Act of 2000, Pub. L. No. 106-573, repealing Pub. L. No. 106-170, § 536(a)(1), *codified at* IRC § 453(a)(1).
10. Notice 2001-22, 2001-12 IRB 1.
11. *E.g.*, *Jim Turin & Sons, Inc. v. Commissioner*, 219 F.3d 1103 (9th Cir. 2000), *aff'g* 75 T.C.M. (CCH) 2534 (1998), discussed in J. Salles, "Tax Accounting," 2(1) *Corp. Bus. Tax'n Monthly* 36, 38 (November, 2000); *RACMP Enterprises v. Commissioner*, 114 T.C. 211 (2000), discussed in J. Salles, "Tax Accounting," 1(9) *Corp. Bus. Tax'n Monthly* 34, 36 (June, 2000); *Smith v. Commissioner*, 80 T.C.M. (CCH) 701 (2000), discussed in J. Salles, "Tax Accounting," 2(4) *Corp. Bus. Tax'n Monthly* 31 (January, 2001).
12. CC-2001-020, Tax Analysts Doc. No. 2001-4417 (Feb. 9, 2001).
13. *DeYoung v. Commissioner*, Docket No. 8734-00.
14. *See* Small Business Tax Accounting Simplification Act of 2000, S. 2246, 106th Cong., 2d Sess. (Mar. 9, 2000), discussed in J. Salles, "Tax Accounting," 1(9) *Corp. Bus. Tax'n Monthly* 34, 37 (June, 2000).
15. Cash Accounting for Small Business Act of 2001, S. 336, 107th Cong., 1st Sess. (Feb. 14, 2001).
16. Cash Accounting for Small Business Act of 2001, H.R. 656, 107th Cong., 1st Sess. (Feb. 16, 2001).
17. 2001-10 I.R.B. 784.
18. 2001-10 I.R.B. 788.
19. *See Schlude v. Commissioner*, 372 U.S. 128 (1963).
20. *See, e.g.*, *George Blood Enterprises, Inc. v. Commissioner*, 35 T.C.M. (CCH) 436 (1972).
21. *Security State Bank v. Commissioner*, 111 T.C. 210 (1998), *aff'd*, 214 F.3d 1254 (10th Cir. 2000); *Security Bank Minnesota v. Commissioner*, 98 T.C. 33 (1992) (reviewed), *aff'd*, 994 F.2d 432 (8th Cir. 1993), *nonacq.*, 1995-2 C.B. 2.
22. *See* I.R.C. §448; *Security State Bank*, 111 T.C. at 214 n.3.
23. AOD 2001-01 (January 30, 2001).
24. Rev. Proc. 2001-25, 2001-12 I.R.B. 1